

EXTERNAL AUDIT CIRCULAR No. 1



CONNECTICUT DEPARTMENT OF TRANSPORTATION

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SUBJECT: Definitions, Audit Authority, and Guidance for Computing Indirect Cost Rates

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These Circulars present interpretative guidance for various categories of costs incurred by Architectural and Engineering firms [A/E firms]. Circular No. 1 is general, in that it presents overall guidance for use in designing accounting systems and preparing indirect cost rate schedules in compliance with Part 31 of the Federal Acquisition Regulations. The remaining ten Circulars deal with specific areas of costs, including;

2. *executive compensation*
3. *professional and consultant service fees*
4. *advertising and selling costs*
5. *vehicle and mileage costs*
6. *rental costs of facilities*
7. *overtime premium*
8. *meals and lodging*
9. *meetings, conferences and retreats*
10. *interest and cost of money*
11. *employee welfare costs*

For more comprehensive guidance, please refer to Chapter 5 of the 2010 Edition of the AASHTO Uniform Audit & Accounting Guide which discusses acceptable cost allocation methodologies, accounting for direct costs and field office accounting.

I. DEFINITIONS

As used in these Connecticut Department of Transportation (CTDOT) External Audit Circulars—

1. "A/E firm" refers to any business entity that performs architectural, engineering, or other design-related services to ConnDOT. In these Circulars, the term "consultant" is used synonymously with "A/E firm."
2. "AASHTO" refers to the American Association of State Highway and Transportation Officials.
3. A cost is "allocable" if it is assignable or chargeable to one or more cost objectives (projects) on the basis of relative benefits received or other equitable relationship. A cost is allocable to a Government contract only if it is incurred specifically for the contract; benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.
4. "Benchmark Compensation Amount" (BCA) is the maximum allowable compensation that may be charged against Federal-aid contracts for any *senior executive* of an A/E firm. The BCA is determined

by the Office of Management and Budget's Office of Federal Procurement Policy (OFPP). The OFPP updates the BCA annually, generally in the month of May.

5. "Benchmark Corporation" refers to any *publicly-owned* United States corporation with annual sales in excess of \$50 million for the fiscal year.
6. The "*Code of Federal Regulations*" (CFR) is the codification of the general and permanent rules published in the *Federal Register* by the executive departments and agencies of the Federal Government.
7. "Compensation" is the total amount of wages, salaries, bonuses, deferred compensation, taxable fringe benefits, and employer contributions to defined contribution pension plans for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the consultant's cost accounting records for the fiscal year.
8. "Contractor" refers to any business entity that provides services under Federal-aid contracts, including A/E consultants and subconsultants.
9. "*Cost Accounting Standards*" (CAS) are issued by the Cost Accounting Standards Board (CASB), a section of the Office of Federal Procurement Policy within the U.S. Office of Management and Budget. The CASB has the exclusive authority to issue and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts that involve Federal funds. The CAS are codified at 48 CFR Chapter 99.
10. "Cost objective" generally means a *contract* for which cost data are desired and for which provision is made to accumulate and measure the cost of associated processes, products, or jobs.
11. The "*DCAA Contract Audit Manual*" (CAM) is the definitive interpretation of FAR Part 31. The CAM is published semiannually by the Defense Contract Audit Agency (DCAA).
12. The "*Federal Acquisition Regulation, Part 31*" (FAR). The FAR is codified at 48 CFR Part 31. The FAR is the primary regulation that governs the acquisition of supplies and services with Federal funds.
13. The "*Federal Travel Regulation*" (FTR) is contained in 41 CFR Chapters 300 through 304. The FTR implements statutory requirements and Executive branch policies for travel by Federal civilian employees and others authorized to travel at the Federal Government's expense. Certain FTR provisions are incorporated into the FAR and may apply to contract costs charged by consultants.
14. The "*Government Auditing Standards*," also known as "Generally Accepted Government Auditing Standards" (GAGAS), are issued by the U.S. Government Accountability Office (GAO).¹ GAGAS prescribe general procedures and professional standards that must be applied when performing audits, reviews, or attestation examinations of commercial entities that conduct business with governmental entities.
15. "Incurred Cost" refers to the various elements of total cost on Consultants' submitted Statements of Direct Labor, Fringe Benefits, and General Overhead; invoices; or other claims for reimbursement. Incurred costs include direct and indirect (overhead) charges, as well as related projects costs such as costs associated with subconsultants.
16. An "incurred cost audit" involves an examination of the accounting records and source documents that support submitted costs billed against Federal-aid contracts. The examination also includes an assessment of the auditee's internal controls, timekeeping practices, and general operating policies.
17. "Internal Controls" are policies, procedures, and activities designed to help an organization achieve its management objectives, safeguard resources, report reliable information, and comply with applicable

¹ *Government Auditing Standards*. This document is commonly referred to as the "GAO Yellow Book."

laws. While internal controls cannot completely eliminate the risk of error, fraud, or mismanagement, well-conceived procedures and a good control environment can minimize the potential for abuse.

18. "Prime consultant" refers to a consulting firm that has contracted directly with ConnDOT to provide architectural, engineering, planning, or environmental-consulting services.
19. "Professional and consultant service fees" represent costs of services rendered by persons who are members of a particular profession or who possess special skills and who are not officers or employees of the prime consultant. Such costs include those of outside accountants, lawyers, actuaries, and marketing consultants.
20. The FAR defines "senior executives" as "the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters."
21. A "Statement of Direct Labor, Fringe Benefits, and General Overhead" is a schedule that shows details regarding a consultant's actual total incurred costs for an accounting period. For enhanced readability, in these Contract Audit Circulars the term "indirect cost rate schedule" is used synonymously with "Statement of Direct Labor, Fringe Benefits, and General Overhead." An Indirect Cost Schedule is presented on the Connecticut Department of Transportation, Office of External Audits web site.
22. The "total cost" that may be billed against a Federal-aid project is the sum of the direct and indirect costs allocable to the contract, plus any allocable cost of money, less any allocable credits.

II. AUTHORITY

CTDOT's authority to conduct incurred-cost audits is granted by 23 U.S.C. sections 112(b)(2)(C) and (D), which provides that contracts or subcontracts funded in whole or in part with Federal-aid highway funds shall be audited in compliance with the cost principles contained FAR Part 31.

III. ISSUE

During an incurred-cost audit, the auditor must determine whether the indirect costs proposed by a consultant are allowable.

IV. ALLOWABILITY

FAR Part 31 establishes minimum requirements regarding the allowability of total costs charged against Federal-aid contracts. This includes provisions for direct project costs, as well as indirect project costs that are used to establish an overhead rate. In conjunction with the FAR's requirements, the Connecticut Department of Transportation (CTDOT) establishes additional clarifying guidance, as appropriate. Specific FAR and CTDOT guidance are discussed in subsequent CTDOT External Audit Circulars.

To be considered *allowable* contract charges, costs submitted by the consultant must be:

1. reasonable,

2. allocable either directly or indirectly to specific contracts,¹
3. allowable in accordance with the FAR,
4. in compliance with terms of the contract, and
5. in compliance with Generally Accepted Accounting Principles (or Cost Accounting Standards, when applicable).

V. APPLICATION

Annually, each consultant must prepare and submit a proposed indirect cost rate that complies with the FAR. The indirect cost rate must be computed based upon actual costs incurred during the consultant's fiscal year. To effect the preparation of its indirect cost rate schedules, the consultant must maintain accounting records that properly accumulate, segregate, and allocate costs as required by the FAR.

Accounting systems with adequate segregation of costs exhibit the following characteristics:

- Direct and indirect expenses are recorded in separate accounts.
- Logically-titled accounts are maintained within each major category of expense.
- Commingling of items is kept to a minimum.
- Allowable and unallowable costs are maintained in separate, dedicated accounts.

Example 1-1. *XYZ Consulting* is an engineering-consulting firm. *XYZ* Employees incurred \$20,000 of indirect food-related costs in 2011. Itemized receipts revealed that \$2,000 of the cost was attributable to entertainment expense. *XYZ* properly recorded \$18,000 in *Account No. 520.00—Meals* and \$2,000 in *Account No. 521.00—Entertainment*. When preparing its 2011 indirect cost rate schedule, the firm identified the balance of *Account No. 521.00* as an unallowable cost and removed it from the overhead-rate computation.

VI. INDIRECT COST-ALLOCATION BASE

CTDOT advocates the use of direct labor cost (DLC) as the primary allocation base for indirect costs. DLC is the preferable allocation base for three reasons. First, most indirect costs incurred in consulting firms is related primarily to supervision and occupancy, both of which tend to vary directly with the cost of professional labor. Second, DLC data are readily available, and computation of the indirect cost rate is a simple and economical process for the consultant. Third, the use of DLC greatly facilitates comparability among firms, and audit verification of claimed indirect costs is relatively straightforward. This is the case because labor costs usually are controlled by payroll records and the general books of account.

NOTE: *All DLC incurred for, and associated with, specific projects must be included in the direct labor base regardless of whether the labor is billed directly to a client. The shifting of unbilled DLC to indirect costs is prohibited by FAR 31.203(b). Additionally, the shifting of DLC between or among different projects is prohibited by FAR 31.202(a).*

In cases where DLC fails to provide an adequate causal link between the incurrence and allocation of costs, it may be permissible to use a secondary allocation base for a portion of the indirect costs. For

¹ See definition I.3 above for more details.

example, costs associated with computer operations may be more equitably assigned to contracts through the use of an allocation base tied to central processing unit time rather than through a DLC base. Thus, for special cost items, deviations from the DLC base will be considered on a case-by-case basis.

VII. INDIRECT COST-RATE COMPUTATION

To compute annual indirect cost rates, consultants must divide total allowable indirect costs (i.e., the sum of general and administrative costs and fringe-benefit costs) by total direct labor. In computing the indirect cost rate, any costs that have been billed directly by the firm must be removed from the indirect cost pool.

An Indirect Cost Schedule is presented on the Connecticut Department of Transportation, Office of External Audits web site.

VIII. AUDIT TESTING

CTDOT auditors may examine proposed indirect costs to determine allowability. Any costs that are prohibited by the FAR or CTDOT External Audit Circulars will be disallowed. In the event that allowable and unallowable costs are commingled in a single account, the auditors will arrive at a disallowance percentage based on a test sample of the account's underlying transactions. This percentage will be applied to the total account balance to arrive at a proposed disallowed dollar amount. Note, however, that this procedure only will be performed in the first indirect cost audit of the consultant. If the same type of commingling occurs in a subsequent year, the entire account balance will be disallowed—unless the consultant prepares a complete, detailed schedule that discloses each allowable and unallowable cost contained within the account in question.

Example 1-2. An examination of *XYZ Consulting's* 2011 accounting records revealed that *Account No. 514.00—General Maintenance* included the following costs: (1) painting and general repairs for *XYZ's* office building and office equipment, and (2) maintenance costs for a building owned by *XYZ Consulting* but leased to an unrelated real estate title agency. When preparing its 2011 indirect cost rate schedule, *XYZ* included the entire \$65,000 balance of *Account No. 514.00* in the indirect cost-rate computation and computed a 140 percent indirect cost rate (based on \$2 million of overhead and \$1,428,571 in direct labor costs).

Analysis: (1) The inclusion of the painting and general repairs for *XYZ's* office building and office equipment are allowable costs, provided that these costs are truly in the nature of repairs and are not required to be capitalized pursuant to the requirements of FASB Statement No. 13. (2) The maintenance costs associated with the building leased to the title agency are unallowable because they are unrelated to any engineering-consulting projects and therefore are not allocable contract costs.

Adjustment: Based on a test sample of the source documents for *Account No. 514.00*, ConnDOT auditors estimated that \$26,000 (40 percent) of the account balance should have been excluded from indirect costs. As a result, *XYZ's* 2011 audited indirect cost rate will reflect a \$26,000 reduction to the numerator of the indirect cost-rate computation, which results in a 138 percent revised indirect cost rate: (\$2 million overhead - \$26,000 audit adjustment) / \$1,428,571 = 138 percent.

Example 1-3. In the following year, CTDOT auditors returned to *XYZ Consulting*. Audit testing revealed that *Account No. 514.00* still contained unallowable costs. Consequently, in computing an audited indirect cost rate, the entire balance of *Account No. 514.00* was disallowed.

IX. REFERENCES

- FAR 31.201-3 (determining reasonableness).
- FAR 31.201-4 (determining allocability).
- FAR 31.205-14 (Entertainment Costs).
- For further guidance, see Titles 23 and 48 of the Code of Federal Regulations and subsequent CTDOT External Audit Circulars.
- AASHTO Uniform Audit & Accounting Guide [2010 Edition]